No. 16,330

United States Court of Appeals

For the Ninth Circuit

CHARLES E. HOPPE, Trustee of the Estate of Los Gatos Lumber Products, Inc., a California corporation, Bankrupt,

Appellant,

vs.

EMMET L. RITTENHOUSE,

Appellee.

APPELLANT'S OPENING BRIEF.

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STATEMENT OF JURISDICTION.

The Referee in Bankruptcy on August 4, 1958, made and entered his Findings of Fact and Conclusions of Law (T.R. p. 13) and Order Allowing Secured Claim (T.R. p. 18), which order was made in proceedings pending in the United States District Court for the Northern District of California, entitled "In the Matter of Los Gatos Lumber Products, Inc., a California corporation," Bankrupt, being No. 47996 in the records and files of said Court.

Appellant's Petition to have the Order reviewed by the District Court was filed on August 29, 1958. (T.R.

p.....). The Petition was timely (11 U.S.C.A. Sec. 67(c)). The District Court had jurisdiction to review the Order (11 U.S.C.A. Section 67(c)). In an Order made on December 19, 1958, the District Court affirmed the Order of the Referee. (T.R. p. 29.) Notice of Appeal therefrom to this Court was filed December 31, 1958. (T.R. p. 29.) The Appeal was timely. (11 U.S.C.A., 48.) The jurisdiction of this Court to review the order of the District Court is sustained by 11 U.S.C.A. 47.

STATEMENT OF QUESTION PRESENTED.

The question before the Court is as to whether the chattel mortgage, which is the basis for Appellee's secured claim, was preferential within the meaning of Sections 60 a and b of the Bankruptcy Act. (11 U.S.C.A., Sections 96 a and b.)

SPECIFICATION OF ERROR.

The Appellant's concise statement of points urged on appeal filed herein (T.R. p. 80) gives in detail the points relied upon by Appellant. They are as follows:

1. That said Order was not supported by the evidence and is contrary to law in that:

(a) The District Court in said Order erred in finding that the Findings of the Referee in Bankruptcy were not "clearly erroneous."

(b) The District Court in said Order erred in holding that the Findings of Fact 4, 5, 6 and 7, and each of

them, were supported by the evidence adduced upon the trial of the issues.

(c) The District Court in said Order erred in sustaining the Order of the Referee in Bankruptcy that the chattel mortgage, which is the subject of controversy herein, was not a preferential transfer within the meaning of Section 60 of the Bankruptcy Act.

STATEMENT OF FACTS.

On January 22, 1957, an involuntary petition in bankruptcy was filed against Los Gatos Lumber Products, Inc., a California corporation, in the Southern Division of the United States District Court for the Northern District of California (T.R. p. 3), and on March 29, 1957, it was duly adjudged bankrupt by said Court (T.R. p. 8). On January 8, 1958, Charles E. Hoppe, Appellant herein, the duly elected, qualified and acting Trustee of the estate of said bankrupt, filed with the said District Court, his objections to the proof of secured claim of Emmet L. Rittenhouse (T.R. p. 10), and on the same date the Referee in Bankruptcy made and entered an Order to Show Cause thereon (T.R. p. 9). Thereafter, after hearings held on said objection and Order to Show Cause on January 31, 1958, and February 21, 1958, the Referee made and entered on August 4, 1958, his Findings of Fact and Conclusions of Law (T.R. p. 13), and his Order Allowing Secured Claim (T.R. p. 18) and thereafter appellant timely filed with the Referee his Petition for Review of said Order (T.R.

p.....) and thereafter hearing was held on said Petition for Review before Honorable Oliver J. Carter, Judge of said United States District Court, and thereafter and on December 19, 1958, Judge Carter made and entered his Order (T.R. p. 29) here appealed from. Said notice of appeal having been filed with said District Court on December 31, 1958 (T.R. p. 29).

Between October 4, 1956, and December 3, 1956, the date promissory note and mortgage of chattels hereinafter referred to bear, Appellee's assignors, Gammill & Company, advanced moneys and/or credit to Los Gatos Lumber Products, Inc., a California corporation, hereinafter referred to as the Corporation, in a sum in excess of $25,000.00 for the purpose of assisting it to stay in business (T.R. p. 34), one of the sources of such funds being from Cyril S. Kelly, Jr. and Marjorie G. Kelly, who desired to be paid by Gammill & Company the sums due them from Gammill & Company (T.R. p. 36).

On December 3, 1956, the Corporation signed a promissory note and chattel mortgage, together with a Notice of Intended Mortgage of Chattels, which Notice recited that said Corporation intended to mortgage to Gammill & Company certain machinery and equipment and other personal property, and that the consideration therefor would be given on December 14, 1956; that after said 14th day of December, 1956, said note and chattel mortgage, together with an assignment of same were delivered to Appellee. Said chattel mortgage was duly recorded on December 19, 1956.

That at all times the Corporation was in need of additional working capital to carry on its business operations. Appellee's assignors knew of the need of the Corporation for additional working capital (T.R. p. 40) and assisted the Corporation in various efforts to obtain financing and were familiar with the value of the assets and equipment of the Corporation.

ARGUMENT.

I. THE GIVING OF THE CHATTEL MORTGAGE WAS A PREFERENCE.

The elements of a preferential transfer are set forth in Sections 60 a and b of the Bankruptcy Act, and are as follows:

(1) Transfer by debtor of his property

(2) Creditors only may be preferred

(3) For or on account of an antecedent debt

(4) When the debtor is insolvent

(5) Within four months of the filing of the petition in bankruptcy

(6) To enable a creditor to obtain a greater percentage of his debt than some other creditor of the same class

(7) That the creditor had reasonable cause to believe that the debtor was insolvent.

That a chattel mortgage is a transfer within the meaning of Section 60a of the Bankruptcy Act is quite clear, 3 *Collier on Bankruptcy,* 14th Ed., Section

60.13, Page 800 and cases therein cited. That the Appellee's assignor Gammill was a creditor and that the chattel mortgage was given on account of an antecedent indebtedness and within four months of bankruptcy, is not contested and we will therefore not expand on those elements at this time. That the allowance of the chattel mortgage did enable this creditor to obtain a greater percentage of his debt than other creditors of the same class is clearly shown by the offer of proof made by counsel for the Appellant Trustee and accepted by Appellee in that the Trustee had on hand the sum of $17,155.16. That he has paid or will be required to pay expenses of administration labor claims in the sum of $1,296.46, priority labor claims in the sum of $1,799.18, and priority tax claims in the sum of $9,641.38, or an aggregate total of $12,-737.02, leaving a balance of less than $5,000.00 to pay the expenses of administration, and a dividend to unsecured creditors in excess of $300,000.00 (T.R. pp. 53-54).

The other two elements, to-wit, the insolvency of the debtor and reasonable cause on behalf of the claimant to believe that the debtor was insolvent, will now be discussed and treated together because of the close relationship between Appellee's assignor Gammill and the bankrupt. It was the testimony of both Gammill (T.R. p. 40) and Morton (T.R. p. 53) that the bankrupt was under capitalized, and that it was necessary for the bankrupt to obtain additional capital in order for it to continue in business, and Gammill well knew of the attempts of the bankrupt to obtain the addi-

tional financing, and, in fact, Gammill assisted in the preparation of the papers for the application to the Small Business Administration for the loan (T.R. p. 53).

It was further the testimony of both Morton and Gammill that they relied on the financial statement of the bankrupt dated July 31, 1956 (Trustee's Exhibit No. 1—T.R. p. 56), and which statement showed a deficit of $66,695.45 and the financial statement dated January 31, 1957 (Trustee's Exhibit No. 2—T.R. p. 56), which showed that as of November 1, 1956, the bankrupt had a deficit of $111,000.00.

Notwithstanding their own testimony and the evidence above referred to, both Morton and Gammill testified that the bankrupt was not insolvent on December 3, 1956, although they both testified that the business would fail without the obtaining of the additional financing (T.R. p. 59). The reason given by Morton and Gammill for their statement that the bankrupt was not insolvent is that they disregarded as a liability the notes due to stockholders which total $173,813.12 by reason of the fact that these note holders agreed to take "equity" stock of an equal amount to the notes which they held (T.R. pp. 57-58). It was Morton's testimony that this surrender of the notes for the stock was conditioned upon obtaining the financing (T.R. p. 60 and T.R. p. 71) and such condition is clearly set forth in the notes of intent, which is part of the application to the Small Business Administration (Claimant's Exhibit No. 4—T.R. p. 70). Gammill testified that he was familiar

with the application at the time of its presentation (T.R. p. 76). In any event, the notes were never surrendered for stock, nor was the additional financing obtained from the Small Business Administration, nor from any other source, and Morton filed a claim in the bankruptcy proceedings (T.R. p. 51). Further, it is submitted that if this procedure had been followed, the financial statement would not have been changed at all, except that the corporation's indebtedness would be to the stockholders, rather than to the note holders.

The test to be applied to determine whether or not a creditor had reasonable cause to believe that the debtor was insolvent is not "actual knowledge" of insolvency, but is "reasonable cause to believe." See 3 *Collier on Bankruptcy,* 14th Ed., Section 60.53, page 989:

> "Knowledge of insolvency is not necessary, nor even actual belief thereof; all that is required is a reasonable cause to believe that the debtor was insolvent at the time of the preferential transfer. *A creditor has reasonable cause to believe that a debtor is insolvent when such a state of facts is brought to the creditor's notice respecting the affairs and pecuniary condition of a debtor, as would lead a prudent business person to the conclusion that the debtor is insolvent."* (Emphasis ours.)

Thus, if the facts are sufficient to put a prudent business person on notice, he is chargeable with notice of all the facts which reasonably diligent inquiry would have disclosed.

Here, Appellee's assignor had *actual* knowledge by reason of his access to the books of the corporation, as well as to his connection with the operation of the business.

II. DISTRICT COURT'S HOLDING THAT REFEREE'S FINDINGS WERE NOT "CLEARLY ERRONEOUS".

The District Judge, in his Order here appealed from (T.R. p. 29), held only that Appellant Trustee's Petition for Review raised questions of fact which were decided by the Referee on conflicting evidence, and affirmed the Referee's Order since he found that said findings were not "clearly erroneous." In this connection we would call the Court's attention to *Costello vs. Fazio,* 256 Fed. 2d 903, wherein this Court, in discussing the general rule of law that the District Court, and this Court on appeal, are required to accept the findings of a Referee in Bankruptcy unless findings are clearly erroneous, and where, at page 908, the Court stated:

> "Where a finding of fact by the referee is based upon conflicting evidence, or where the credibility of witnesses is a factor, a district court and, on appeal, a court of appeals, will seldom hold such a finding clearly erroneous. *The same reluctance is not encountered with regard to a factual conclusion from given facts.* In the latter case, the proper conclusion from given facts can be made by the trial judge, or the court of appeals, as well as the referee." (Emphasis ours.)

Here, the evidence, in our opinion, was not even conflicting, in that both Morton and Gammill testi-

fied that the money owed to the Morton family was to be treated as "equity stock" and that therefore the corporation was solvent. However, the actual fact admitted by both Gammill and Morton in that they were familiar with the contents of the application to the Small Business Administration, was that the Morton family indebtedness was actually an indebtedness of the bankrupt, and that it was the Morton family intent to convert the same to common stock in the bankrupt predicated upon (1) all other Morton family creditors of the bankrupt similarly converting their notes into stock, and (2) upon the bankrupt obtaining from the Small Business Administration a loan of $150,000.00 to $175,000.00 within ninety days from September, 1956 (Claimant's Exhibit No. 4, T.R. p. 70). That the Small Business Administration Loan was not, on the date of the giving of the mortgage by the bankrupt to Gammill, or at any other time, obtained, and that the Morton family did not convert their notes to stock, was conceded by both Morton and Gammill, and is further substantiated by the filing by Morton, Mrs. Morton and Morton's mother of proofs of claim in the bankruptcy proceedings based upon the notes.

The Referee (T.R. p. 68) correctly stated the question:

> "I think both you gentlemen and the Court will agree that the crux of this matter is that the money due these people was the difference between solvency and insolvency at the time of payment, that is the whole case as the Court sees it."

but reached a clearly erroneous factual conclusion from given facts.

In view of the facts and law hereinabove set forth, it is Appellant's contention that the chattel mortgage given by said bankrupt to said Appellee's assignor was and is a preference voidable under the provisions of Sections 60 a and b of the Bankruptcy Act, and that the Order here complained of should be, by this Court, reversed, and remanded with instructions to the Referee in Bankruptcy to make and enter an order in said bankruptcy proceedings that said proof of claim of said Emmet L. Rittenhouse be allowed only as a general, unsecured claim.

Dated, Burlingame, California,
June 29, 1959.

Respectfully submitted,
SHAPRO & ROTHSCHILD,
By ARTHUR P. SHAPRO,
Attorneys for Appellant.

DANIEL ARONSON, JR.,
Of Counsel.

(Appendix A Follows.)

Appendix.

Appendix A

TABLE OF EXHIBITS
Rule 18 2(f)

TRUSTEE'S EXHIBITS

CLAIMANT'S EXHIBITS